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ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
TONY WEST
Commissioner

Arizona Corporation Commission

DOCKETED

JUN 04 1999

DOCKETED BY

MJ

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR APPROVAL OF ITS PLAN
FOR STRANDED COST RECOVERY

DOCKET NO. E-01345A-98-0473

IN THE MATTER OF THE FILING OF
ARIZONA PUBLIC SERVICE COMPANY
OF UNBUNDLED TARIFFS PURSUANT TO
A.A.C. R14-2-1601 et seq.

DOCKET NO. E-01345A-97-0773

IN THE MATTER OF COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-0165

**NOTICE OF FILING DIRECT
TESTIMONY OF KEVIN HIGGINS**

Pursuant to the Commission's Procedural Order dated May 25, 1999, counsel for Cyprus Climax Metals Company, ASARCO Incorporated, Enron Corp. and Arizonans for Electric Choice and Competition herein undersigned, hereby provides notice of the filing of the Direct Testimony of Kevin C. Higgins in the above-captioned dockets.

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1 DATED this 4th day of June, 1999.

2 FENNEMORE CRAIG, P.C.

3
4 By 

C. Webb Crockett

Jay L. Shapiro

Suite 2600

3003 North Central Avenue

Phoenix, Arizona 85012

7 Attorneys for ASARCO Incorporated, Cyprus
8 Climax Metals Company, Enron Corp. and
Arizonans for Electric Choice and Competition

9 ORIGINAL AND TEN COPIES
10 of the foregoing hand-delivered
this 4th day of June, 1999, to:

11 Arizona Corporation Commission
12 Docket Control
1200 West Washington Street
Phoenix, Arizona 85007

13 COPIES OF THE FOREGOING
14 hand-delivered this 4th day
of June, 1999 to:

15 Carl J. Kunasek
16 Chairman
Arizona Corporation Commission
17 1200 West Washington
Phoenix, Arizona 85007

18 Jim Irvin
19 Commissioner
Arizona Corporation Commission
20 1200 West Washington
Phoenix, Arizona 85007

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8 COPY OF THE FOREGOING
mailed this 7th day of June, 1999 to:

9 RE-00000C-94-0165 Service List

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By: 

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DIRECT TESTIMONY OF KEVIN C. HIGGINS

Q. Please state your name and business address.

A. Kevin C. Higgins, 39 Market Street, Suite 200, Salt Lake City, Utah, 84101.

Q. By whom are you employed and in what capacity?

A. I am employed by Energy Strategies, Inc. (ESI) as a senior associate. ESI is a private consulting firm specializing in the economic and policy analysis applicable to energy production, transportation, and consumption.

Q. On whose behalf are you testifying in this proceeding?

A. My testimony is being sponsored by Arizonans for Electric Choice and Competition¹.

Q. What are your qualifications to testify in this proceeding?

A. My academic background is in economics, and I have completed all course work and examinations toward the Ph.D. in Economics at the University of Utah, and have served on the adjunct faculties of both the University of Utah and Westminster College. Prior to joining ESI, I held policy positions in state and local government. From 1983 to 1990, I was economist, then assistant director, for the Utah Energy Office, where I testified regularly before the Utah Public Service Commission on matters involving structural change in the provision of energy services, including introduction of retail competition in the natural gas industry, implementation of rules governing small power production and cogeneration, joint ownership of electric transmission facilities, and the merger between major electric utilities. From 1991 to 1994, I was chief of staff to the

¹ Arizonans for Electric Choice and Competition is a coalition of energy consumers in favor of competition and includes Cable Systems International, BHP Copper, Motorola, Chemical Lime, Intel, Honeywell, Allied Signal, Cyprus Climax Metals, Asarco, Phelps Dodge, Homebuilders of Central Arizona, Arizona Mining Industry Gets Our Support, Arizona Food Marketing Alliance, Arizona Association of Industries, Arizona Multihousing Association, Arizona Rock Products Association, Arizona Restaurant Association, Arizona Association of General Contractors, Arizona Retailers Association, Boeing, Arizona School Board Association, National Federation of Independent Business, Arizona Hospital Association, Lockheed Martin, Abbot Labs, and Raytheon.

1 chairman of the Salt Lake County Commission, one of the larger municipal governments
2 in the western U.S., where I was responsible for development and implementation of a
3 broad spectrum of public policy. In 1995, I joined ESI, where I assist private and public-
4 sector clients in the area of energy-related economic and policy analysis, including the
5 provision of expert testimony. A more detailed description of my qualifications is
6 contained in Exhibit KCH-1, attached to this testimony.

7 **Q. What has been your involvement in the electric industry restructuring effort in**
8 **Arizona?**

9 A. For much of 1996, I was involved in the workshop process conducted by the
10 Arizona Corporation Commission to develop rules governing the implementation of retail
11 access. In 1997, I participated in the Working Group process established by the
12 Commission, serving as a consumer representative on the Stranded Cost Working Group;
13 as part of that effort, I participated in each of the Working Group's three subcommittees. I
14 also participated actively in the Reliability & Safety, Customer Selection, ISO, and
15 Unbundled Services & Standard Offer Working Groups established by the Commission.
16 Concurrently, I have been actively involved in the Desert STAR independent system
17 operator (ISO) feasibility assessment, participating on the Steering Committee, in the
18 Pricing and Operations Working Groups, and on the Legal & Negotiating Committee.

19 In 1998, I provided direct and rebuttal testimony before this Commission on
20 stranded cost recovery in the electric competition hearing, and submitted testimony on the
21 previously-proposed Arizona Public Service (APS) and Tucson Electric Power
22 settlements at the end of that year. I also provided extensive comments to the SRP Board
23 as part of its effort to implement retail competition. I have also been very involved in
24 addressing transmission access issues; I serve on the Board of the Arizona Independent
25 Scheduling Administrator (AISA) and have been chairing its Operating Committee,
26 which is responsible for drafting the AISA's Protocols Manual.

1 **Q. What is the purpose of your testimony today?**

2 A. My testimony addresses the Settlement Agreement between AECC, RUCO,
3 Arizona Community Action Association, and APS. I believe this settlement is in the
4 public interest and I recommend that the Commission approve it.

5 **Q. On what basis are you familiar with the Settlement Agreement?**

6 A. On behalf of AECC, I helped to negotiate the Settlement Agreement.

7 **Q. Why do you believe the Settlement Agreement is in the public interest?**

8 A. The Settlement Agreement provides a comprehensive resolution to many of the
9 difficult issues associated with effecting a transition to retail competition in APS'
10 distribution territory. The Settlement Agreement resolves these issues fairly, providing
11 significant benefits to customers in the form of rate reductions and viable competitive
12 options. Stranded cost recovery is resolved through a compromise that allows APS to
13 recover \$350 million (present value) in stranded cost through 2004, while incurring a
14 \$234 million (nominal) disallowance. The Competitive Transition Charge (CTC) that is
15 levied to recover stranded cost declines each year through 2004, as does the regulatory
16 asset payment by competitive customers, which is included in the unbundled distribution
17 charge. The combination of a declining CTC and a declining regulatory asset payment
18 (via the unbundled distribution charge) results in a progressively smaller regulatory cost
19 hurdle for customers to access the competitive market. Simultaneously, Standard Offer
20 rates decline each year of the transition through 2003. Further, the Settlement Agreement
21 commits APS to assuring non-discriminatory access to the transmission system through
22 active support of the formation of the Desert STAR ISO and adherence to the AISA
23 protocols.

24 **Q. How is your testimony organized?**

25

26

1 A. I will address key terms of the Settlement Agreement generally in the order in
2 which they appear in the agreement. I will explain why, from a customer perspective, I
3 believe these terms are fair and reasonable.

4 **Implementation of retail access**

5 **Q. How does the implementation of retail access in the Settlement Agreement compare**
6 **with the implementation in the Commission's proposed Electric Competition Rules?**

7 A. The start date for opening retail access to all customers is the same – January 1,
8 2001. During the phase-in, Section 1.1 of the Settlement Agreement allows for an
9 additional 140 MW of competitive load being made available by APS for eligible non-
10 residential customers. This additional 140 MW restores the non-residential share of the
11 phase-in amount that these customers lost in December 1998 when the Commission
12 raised the residential set-aside from the 4 percent that had been originally proposed in the
13 Rules to 10 percent. (Because the total amount of load eligible for competition had not
14 been increased in the Rules, raising the residential set-aside had the effect of lowering the
15 amount of load eligible for competition for other customers.) The Settlement Agreement
16 does not impact the 10 percent set-aside for residential customers. Thus, the Settlement
17 Agreement increases the total amount of load that is eligible for competition during the
18 phase-in, while providing the level of residential participation required by the proposed
19 Rules.

20 **Rate matters**

21 **Q. What rate changes result from the Settlement Agreement?**

22 A. Two major rate changes are implemented: Standard Offer rates will decline in a
23 specified amount each year through 2003 (Section 2.2), and unbundled tariffs are issued
24 for competitive service (Section 2.1). The unbundled tariff rates also decline a specified
25 amount each year (Exhibit A, Schedules A and B).
26

1 The Settlement Agreement establishes regulated retail rates through July 1, 2004.²
2 Subsequently, rates are to be established pursuant to a general rate case, which APS will
3 file by June 30, 2003 (Section 2.7).

4 **Q. What is the reduction in Standard Offer rates?**

5 A. For all residential customers, there will be successive 1.5 percent reductions in
6 Standard Offer rates in July 1999, July 2000, July 2001, July 2002, and July 2003, for a
7 cumulative reduction of 7.5 percent. The same rate reduction will apply to all non-
8 residential Standard Offer rates for service provided below 3 MW. For industrial-type
9 service, i.e., 3 MW or greater, Standard Offer rates will decline as follows: 1.5 percent in
10 July 1999 and July 2000, 1.25 percent on July 2001, and .75 percent in July 2002, for a
11 cumulative reduction of 5 percent.

12 **Q. How does the Standard Offer rate reduction in this Settlement Agreement compare**
13 **with the rate reduction that had been proposed in the (expired) Settlement**
14 **Agreement that APS had negotiated with Staff in late 1998?**

15 A. The rate reductions in this Settlement Agreement are greater for all Standard Offer
16 customers. The previous settlement would have reduced residential rates 1 percent each
17 year from July 1999 through July 2002, for a total of about 4 percent – compared with 7.5
18 percent in the current agreement. Furthermore, under the previous agreement, non-
19 residential rates would have declined 1 percent in July 1999 and July 2000 for a total of
20 about 2 percent – compared with 7.5 percent for commercial-size customers and 5 percent
21 for industrial-size customers under the current agreement.

22 **Q. Please describe the unbundled tariffs that are issued as part of the Settlement**
23 **Agreement.**

24 A. The unbundled tariffs will provide direct access service for each major category of
25 APS customer: residential, general service, extra-large general service, and contract

26 ² The exception is the CTC, which is set through December 31, 2004.

1 (when contracts terminate). The unbundled components in each tariff consist of basic
2 delivery, distribution, system benefits, and the CTC. In addition, there are unbundled
3 billing credits for metering, meter reading, and billing when those services are provided
4 by the customer's electric service provider (ESP).

5 **Q. How are APS' regulatory assets recovered in the unbundled tariff?**

6 A. Full recovery of regulatory asset is included in the distribution charge of each
7 unbundled tariff.

8 **Q. How are transmission and ancillary services costs recovered?**

9 A. APS will not bill retail customers directly for transmission service and ancillary
10 services. Instead, these services will be billed, when appropriate, to the scheduling
11 coordinators who will be submitting hourly load and resource schedules on behalf of
12 ESPs. Eventually, these costs likely will be passed on to retail customers by their
13 respective ESPs. The rates that APS intends to charge scheduling coordinators for
14 transmission and ancillary services have been provided to me as part of the settlement
15 negotiations. They are generally comparable to the rates now found in APS' Open
16 Access Transmission Tariff (OATT) approved by FERC.

17 **Q. Why are there separate unbundled tariffs for BHP Copper, Cyprus Bagdad, and**
18 **Ralston Purina?**

19 A. These customers take service today under special contracts. The unbundled tariffs
20 for these customers would govern direct access service upon termination of the current
21 contracts. Consistent with the proportionality provision of the proposed Rules, the
22 unbundled rates for these customers are calculated to continue, at the time each contract
23 terminates (2001), the level of contribution to stranded cost recovery that is included in
24 the respective current bundled-service contract rates. Thereafter, the CTC and regulatory
25 asset payments decline at the same rate as that of the extra-large general service tariff. All
26 the other unbundled rates for these customers – basic service charge, system benefits, and

1 the non-regulatory asset portion of distribution service – are the same as that of the
2 unbundled tariff for extra-large general service.

3 **Q. What is the basis for the reduction in the unbundled tariffs in future years?**

4 A. The rates in the unbundled tariffs are set in advance through July 1, 2004. A major
5 advantage of this approach is that it provides direct access customers with price certainty
6 regarding the regulated portion of their bills. The CTC and distribution rates are reduced
7 each year during the transition period in accordance with Schedule A and Schedule B,
8 respectively, of Exhibit A. The CTC declines January 1 of each year and is calculated to
9 recover \$350 million in present value when levied against the kWh expected to be
10 delivered to all retail load in the APS distribution territory from January 1, 1999 through
11 December 31, 2004.³ There are two main reasons for the annual decline in the CTC: (1)
12 increased kWh sales, which lowers the per-unit cost of stranded cost recovery, and (2)
13 smaller amounts of annual stranded cost in future years, based on APS' net revenues lost
14 calculation.

15 The unbundled distribution rates also decline on January 1 for each year of the
16 transition period. This decline results from the annual reduction in the regulatory asset
17 portion of the distribution charge. The percentage decline in the regulatory asset portion
18 of the distribution charge is the same for all direct access customers; by January 2004, the
19 regulatory asset portion of the distribution charge will be approximately 35 percent lower
20 than in 1999.

21 **Q. What are the implications for the competitive market of the declining CTC and**
22 **declining regulatory asset portion of the distribution charge?**

23 A. The competitive market will benefit from this design feature. The combination of
24 a declining CTC and a declining regulatory asset payment (via the unbundled distribution

25 ³ For the years 1999 and 2000, the contribution to the \$350 million stranded cost recovery will be applied to 20
26 percent of the kWh delivered to all retail load, consistent with the assumptions used in APS' calculation of its
stranded cost. See Exhibit B.

1 charge) results in a progressively smaller regulatory cost hurdle for customers to access
2 the competitive market each year. My assessment of the unbundled tariffs is that at
3 current market prices they will allow customers to benefit from competition right away,
4 and benefit even more in the future. For example, I estimate that an ESP serving a
5 commercial customer in 2000 would have a margin of 5.1 mills per kWh between the
6 wholesale price and the Standard Offer rate from which to offer the customer savings. In
7 2001, this margin grows to 6.1 mills – even as the Standard Offer declines. By way of
8 comparison, under the previously-proposed settlement (1998), the comparable margin
9 was 2.2 mills for all years. Of course, under the current Settlement Agreement, as the
10 market price of power changes, so does the margin – up or down.

11 **Q. How are Standard Offer and unbundled rates established after July 1, 2004?**

12 A. As I indicated above, rates after that time are to be established pursuant to a
13 general rate case, which APS will file by June 30, 2003 (Section 2.7). The timing of the
14 general rate case is significant: APS' regulatory assets are scheduled to be fully amortized
15 by July 1, 2004. In addition, the CTC expires six months later. All things being equal,
16 customers would be entitled to significant rate reductions following the regulatory asset
17 amortization and the CTC expiration. At the same time, to the extent that APS may
18 experience increased costs associated with its regulated service, the utility can seek to
19 recover such costs as part of the general rate case. Further, certain adjustment clauses
20 (Section 2.6), discussed below, are scheduled to be implemented beginning July 1, 2004.

21 **Q. Please explain the adjustment clauses that appear in Section 2.6.**

22 A. Section 2.6 identifies four categories of cost that are to be recovered through two
23 basic types of adjustment clauses beginning July 1, 2004. The first type of adjustment
24 clause applies to cost items (1) and (2) of Section 2.6; it is associated with the costs of
25 providing Standard Offer service, and is applicable only to Standard Offer rates. Note that
26 cost item (1) – obligations associated with “provider of last resort” and Standard Offer

1 service – is intended to apply to *deviations* in the cost of providing Standard Offer service
2 above or below the amount recovered in base rates after July 1, 2004. By that time, APS
3 will be acquiring all of its resources for Standard Offer service from the wholesale
4 market. The cost of such acquisitions may be greater than or less than the cost built into
5 rates; consequently, the adjustment clause may be either positive or negative. Prior to
6 July 1, 2004, there is no adjustment clause, and APS is at risk for recovering the
7 obligations in cost item (1).

8 The second basic type of adjustment clause is applicable to all customers –
9 Standard Offer and competitive. It pertains to cost item (3), compliance with the Electric
10 Competition Rules, and cost item (4), system benefits costs that are not included in rates
11 as of June 30, 1999.

12 **Q. Does applying an adjustment clause to APS' costs of complying with the Electric**
13 **Competition Rules constitute a "blank check" for the utility?**

14 **A.** Applying an adjustment clause to this cost item is not intended to be a blank
15 check for the utility. Before costs can be included in the adjustment clause(s), they must
16 be found by the Commission to be reasonable and prudent. The parties to this agreement
17 are not waiving their rights to review, and if necessary, challenge the reasonableness,
18 prudence, or proper classification of any of the costs that APS proposes to recover
19 through the adjustment clause(s).

20 **Regulatory assets and stranded costs**

21 **Q. What is the basis for the \$350 million in stranded cost recovery provided in Section**
22 **3.3 of the Settlement Agreement?**

23 **A.** It is based on a compromise among the parties. A present value of \$350 million
24 corresponds to about 66 percent of the \$533 million in stranded cost calculated by APS.
25
26

1 **Q. Does the Settlement Agreement assure recovery of the \$350 million?**

2 A. Yes, it does. Section 3.3 provides that the recovery of stranded cost will be
3 tracked in accordance with the CTC values shown in Exhibit B, which in turn, correspond
4 to the CTC that will be levied on customers, as shown in Exhibit A, Schedule A. The
5 values in Exhibit B will recover a present value of \$350 million in stranded cost if the
6 amount of retail kWh delivered in the APS distribution territory is equal to APS' forecast.
7 If a greater amount of kWh is delivered than forecast, it will result in more than \$350
8 million being collected during the transition period; if fewer kWh are delivered, it will
9 result in less being collected. Section 3.3 provides that, as of December 31, 2004, any
10 excess recovery or under recovery of the \$350 million is to be applied to the adjustment
11 mechanism set forth in Section 2.6 (3).

12 **Q. Does the Settlement Agreement provide for full recovery of APS' regulatory assets?**

13 A. Yes. For Standard Offer customers, the recovery of regulatory assets is included
14 in the Standard Offer rate. For retail access customers, full payment for regulatory asset
15 recovery is included in the distribution charge of each unbundled tariff.

16 **Corporate structure**

17 **Q. Why does Section 4.1 of the Settlement Agreement provide APS a two-year**
18 **extension for forming its competitive affiliate?**

19 A. My understanding is that such an extension will allow APS to save significant
20 costs in effecting the separation; such savings will reduce the amount that APS will seek
21 to recover in the adjustment clause described in Section 2.6 (3).

22 **Q. Section 4.4 of the Settlement Agreement states that its approval by the Commission**
23 **shall be deemed to include certain specific determinations in support of an APS**
24 **application to FERC for exempt wholesale generator (EWG) status. Does this**
25 **provision bind the parties or the Commission to any position in any future**
26

1 **proceedings before FERC regarding its regulation of APS' wholesale generation**
2 **rates?**

3 A. No. If the APS affiliate is successful in being designated an EWG by FERC, it
4 does not mean that FERC would necessarily relinquish its regulation of the affiliate's
5 wholesale generation rates. In fact, if FERC were to determine that the APS generation
6 affiliate had significant market power, one would expect FERC to impose price caps on
7 the affiliate's wholesale generation sales. In Section 4.6 of the Settlement Agreement, the
8 parties reserve their rights under Sections 205 and 206 of the Federal Power Act to appear
9 before FERC and argue their respective positions with respect to the rates of any APS
10 affiliate formed under Article IV of the Settlement Agreement.

11 **Miscellaneous – Transmission Access**

12 Q. **What provisions are made to ensure non-discriminatory access to the transmission**
13 **system?**

14 A. Over the past two years, stakeholders in the southwest have been negotiating the
15 terms of transmission access. The long-term resolution of this issue lies in the formation
16 of the Desert STAR Independent System Operator, and the interim solution requires
17 implementation of the AISA protocols and its oversight. Section 7.6 of the Settlement
18 Agreement requires APS to actively support the AISA and the formation of the Desert
19 STAR Independent System Operator. In addition, APS agrees to modify its OATT to be
20 consistent with any FERC-approved AISA protocols, and to file such changes within ten
21 days of Commission approval of the Settlement Agreement. I believe these provisions are
22 the appropriate steps for ensuring non-discriminatory access to the transmission system

23 **Miscellaneous – Code of Conduct**

24 Q. **What is the purpose of the code of conduct provisions in Section 7.7 of the**
25 **Settlement Agreement?**

1 A. In my opinion, the establishment of effective rules governing affiliate
2 relationships is an integral part of successfully implementing retail competition. In the
3 proposed Electric Competition Rules, this function had been fulfilled, in part, by the
4 "Affiliate Transactions" section. Unfortunately, however, the "Affiliate Transactions"
5 section was deleted from the proposed Rules and replaced with a requirement that
6 Affected Utilities file a code of conduct within ninety days of the adoption of the Rules.
7 The code of conduct is intended to prevent anti-competitive abuses and must be approved
8 by the Commission.

9 The Settlement Agreement contemplates that APS' code of conduct filing will
10 proceed in accordance with the Commission's proposed Rules. The parties to the
11 Settlement Agreement are free to participate in any such proceeding and to advocate their
12 own positions at such time. In the meantime, APS will adhere to a voluntary, interim
13 code of conduct that will be served on the parties within thirty days of Commission
14 approval of the Settlement Agreement.

15 I believe that given the deletion of the "Affiliate Transactions" section of the
16 proposed Rules, the approach taken in the Settlement Agreement is the most reasonable
17 way to address code of conduct issues without further delaying the start of competition.

18 **Conclusion**

19 **Q. In conclusion, what is your recommendation to the Commission regarding the**
20 **Settlement Agreement?**

21 A. I believe that the Settlement Agreement is in the public interest. The Settlement
22 Agreement provides a comprehensive resolution to many of the difficult issues associated
23 with effecting a transition to retail competition in APS' distribution territory. The
24 Settlement Agreement resolves these issues fairly, providing significant benefits to
25 customers in the form of rate reductions and viable competitive options. The combination
26 of a declining CTC and a declining regulatory asset payment (via the unbundled

1 distribution charge) results in a progressively smaller regulatory cost hurdle for customers
2 to access the competitive market each year. Simultaneously, Standard Offer rates decline
3 each year of the transition through 2003. Further, the Settlement Agreement commits
4 APS to assuring non-discriminatory access to the transmission system through active
5 support of the formation of the Desert STAR ISO and adherence to the AISA protocols.

6 I recommend that the Settlement Agreement be approved by the Commission.

7 **Q. Does this conclude your direct testimony?**

8 **A. Yes, it does.**